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19	C/IPD/OIS				
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21	ANIO/USSR		X		
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Remarks: These are two additional pages which should be inserted after Options for Agriculture in the package that was circulated earlier for the NSC meeting tomorrow on US-EC Economic Relations.

Executive Secretary

15 July 82

Date

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Remarks:
Please forward coordinated comments to [redacted] by COB 15 July.

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Executive Secretary
15 July 82
Date

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NATIONAL SECURITY COUNCIL
WASHINGTON, D.C. 20506

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July 15, 1982

MEMORANDUM FOR

Ms. Nancy Bearg Dyke
Assistant to the Vice President
for National Security Affairs

Mr. L. Paul Bremer, III
Executive Secretary
Department of State

Mr. David Pickford
Executive Secretary
Department of the Treasury

Lt Col Richard Higgins
Assistant for Interagency Matters
Office of the Secretary of Defense

Mr. F. Henry Habicht
Special Assistant to the Attorney General

Mr. Raymond Lett
Executive Assistant to the Secy
Department of Agriculture

Ms. Helen Robbins
Exec Asst to the Secy
Department of Commerce

Mr. William V. Vitale
Director, Office of Executive Secretary
Department of Energy

Mr. William Schneider
Associate Director for National Security and International Affairs
Office of Management and Budget

Mr. Thomas B. Cormack
Executive Secretary
Central Intelligence Agency

Ms. Jackie Tillman
Executive Assistant to the United States to the United Nations

Mr. Dennis Whitfield
Executive Assistant to the USTR

Mr. James B. Burnham
Executive Assistant to the Chairman, Council of Economic Advisors

Col George A. Joulwan
Exec Asst to the Chairman, Joint Chiefs of Staff

SUBJECT: Background Papers for NSC Meeting, July 16, 1982

Attached are background papers for the NSC Meeting on US-EC Economic Relations which is scheduled for July 16, 1982, at 11:00 a.m., in the Cabinet Room. (C)

Michael O. Wheeler

Michael O. Wheeler
Staff Secretary

Attachments
Background Papers

8223

Discussion Paper for NSC Meeting, July 16, 1982

OPTIONS ON STYLE AND APPROACH

In managing current issues with its European Allies, there are a number of ways in which the United States could respond to European concerns:

1. A visible, high-level response beginning a "new dialogue."

   This option could involve a variety of new steps, such as sending a Cabinet-level delegation to Europe or inviting the EC COuncil President to visit President Reagan, to demonstrate special sensitivity to European concerns. Such steps could be undertaken to negotiate specific issues or to reinforce existing negotiations within regular channels. This approach will inevitably raise some expectations of high-level compromises on the oustanding issues.

2. Address key issues through existing channels with greater intensity and commitment.

   This option precludes any special steps outside existing channels and ongoing negotiations but implies a commitment to pursue existing negotiations with greater vigor and willingness to achieve compromises on individual issues based on mutual concessions.

3. Some combination of one and two above.

   This option involves special high-level steps including the designation of a Cabinet-level official or officials to carry on intensified negotiations with the Europeans, combined with enhanced commitments to pursue solutions to other issues in existing channels. This appraoch also implies a U.S. willingness to compromise.

4. Pursue business-as-usual in US-European economic relations.

   This option involves focusing on already scheduled events and negotiations in US-EC relations and pursuing these activities in line with recent levels of emphasis (i.e., pre-Summit and since). No special high-level activities would be considered. This approach implies that the US intends to hold its positions on the issues, and use existing machinery to keep pushing our points.

OPTIONS ON SPECIFIC ISSUES

Whatever approach the United States chooses, it is essential to consider beforehand how we intend to proceed on specific issues. Otherwise, we risk raising expectations through high-level contacts which cannot be met through negotitions on specific issues.

The issue papers attached to this discussion paper outline the present status of various issues in US-European relations. As the overview paper suggests, the issues divide generally into three categories:

1 Issues such as East-West trade, sanctions, export credits and economic and monetary policy coordination, where there is general agreement that US policy is developing in the right direction and should emphasize the broad policy rationale these initiatives, addressing specific issues such as sanctions or high interest rates in the context of overall US and Western security and economic policy objectives.

2. Other individual issues such as steel, agriculture, textiles and various domestic actions that would benefit the allies, where the United States may have some flexibility, in timing or style if not in substance, and can seek to develop maneuvering room fully aware of the legal and other limits and the desire not to raise expectiations which cannot be fulfilled.

3. Long-term issues such as US policy toward the GATT Ministerial or the IMF and multilateral development banks, where US leadership and continuity of policy are too important to alter for short-term objectives.

Below, some alternatives are outlined to initiate thinking and discussion about US options in specific areas, particularly in the second category of issues above.

OPTIONS ON STEEL

Any solution to the steel problem as required by the statute must relieve injury to the US industry caused by subsidized or dumped EC steel imports. The US industry can block any settlement which does not meet this condition.

1. EC-wide settlement. Secretary Baldrige continues his current intensive effort to settle the steel cases through negotiations with European Commission officials.

2. Country-by-country settlement on products subject to pending cases. If EC-wide settlement appears impossible, individual countries may seek separate settlements in pending cases. Any such country/product specific settlement acceptable to the foreign country probably would not meet the statutory requirement of relieving injury to the US industry.

3. Completion of pending cases. If neither EC-wide settlement nor country-wide settlement is possible, the Department of Commerce has no choice under the statute but to continue the cases to their conclusion. This will, no doubt, result in the exclusion of major steel imports from France, Belgium, Italy, and the United Kingdom.

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OPTIONS ON AGRICULTURE

1. Continue to press vigorously on current agreed stragegy.

2. Soften the current approach.

   -- Limit debate to government-to-government dealings, i.e., remove debate from public domain;

   -- Extend time period for review of 301 petitions.

3. Strengthen the current approach.

   -- Establish a limited export credit subsidy program;

   -- Establish a limited direct export subsidy program designed for particular market and particular commodity such as poultry in the Middle East.

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TABLE OF CONTENTS

U.S.-EUROPEAN ECONOMIC RELATIONS

AN OVERVIEW

ISSUES

The confluence of a number of contentious issues in U.S.-EC economic relations has produced strong reactions in Europe. Key among these issues are: (1) the decision to extend extraterritorially the sanctions on oil and gas equipment and technology; (2) Commerce preliminary determinations on European steel subsidies; and (3) U.S. complaints against EC agricultural subsidies in the GATT (General Agreement on Tariffs and Trade).

These disputes threaten to color overall U.S.-EC relations, despite earlier progress in a number of areas -- including agreement at the Versailles Summit on future economic policy consultations, a study of the effect of past exchange rate interventions, and a narrowing of the gap on North-South issues. We have also recently achieved EC agreement to an extension of the international arrangement on export credits, including substantial increases in export credit rates for the Soviet Union.

The European nations are generally united in their strong opposition to the oil and gas equipment decision, but differences exist within the Community on both the steel and agriculture issues. As the United States has moved to challenge subsidy practices in international trade and as the current confrontation with the EC in steel has developed, the EC continually has attempted to discuss our bilateral trade relations in the broader context of U.S.-European security and political issues. Prior to the pipeline decision, U.S. representatives had some success in limiting this linkage, and in persuading the EC that the issues should be managed individually through the proper GATT and OECD mechanisms.

The Europeans also have argued that the oil and gas equipment decision casts doubt on the Summit process and consultations generally between the U.S. and its allies. The Heads of Government of the European Community have called for a genuine and effective dialogue with the United States and stated their determination to defend vigorously its legitimate interests in GATT. The Europeans have already announced their intention to distance themselves from the GATT Ministerial planning process in Geneva and have questioned the continuing utility of the Ministerial given current economic problems.

Unless the United States addresses these concerns, the Community may well be led to undertake specific retaliatory actions or to adjust its broader policies in GATT or elsewhere to conflict more sharply with U.S. objectives. Continued poor economic relationships can make it more difficult for us to gain and maintain the cooperation of our allies on security and diplomatic issues.

The poor state of the economies in both the United States and Europe has increased the political sensitivity on these economic issues in both Europe and the United States. The threat of protectionism, which lurks in the current economic environment, permits no hesitation in the Administration's policies to pursue specific as well as broad goals in GATT. Yet Europeans see our efforts to force an end to EC steel and agriculture subsidies which disrupt trade as confrontational and "kicking them while they are on their knees."

NATURE OF U.S. RESPONSE

In responding to this situation, U.S. policy should stress continuity, consistency, a low-key action-oriented approach, and above all, not raise expectations that cannot be fulfilled. Rather than being defensive or apologetic, we should approach the Europeans with a sincere desire to pick up on their appeal for a genuine and effective dialogue, pointing out that such a dialogue cannot continue to focus on U.S. policies alone.

In this broader context, the U.S. should distinguish among the various specific issues we face and the manner in which we proceed to address them. Where we have flexibility, we should also be more sensitive to timing of our decisions and announcements. Poor timing can give the appearance of a coherent anti-European policy where none exists.

Moreover, we should recognize that U.S.-EC differences on East-West trade issues will not be easily resolved. However, we can seek to establish an improved framework for U.S.-EC cooperation and mutual understanding and to maintain progress toward our basic economic objectives -- despite these differences -- if the EC is willing to divorce East-West disputes from other trade issues. This requires an EC recognition that we can have differences and still maintain an economic/political alliance.

1. On certain issues, such as East-West trade, sanctions, export credits, and economic policy coordination, we should proceed with a stress on the larger policy rationale.

2. On other issues, such as steel, agriculture, textiles, and various domestic actions that would benefit the allies, we should search for maneuvering room or flexibility, fully aware of the limits and of the desire not to raise expectations.

3. Finally, on the broadest issues of U.S. trade policy in GATT and U.S. policy toward the IMF and MDBs, the United States should maintain its leadership and continuity of policy, seeking to improve the operation of the international economic system. Obviously, our ability to find flexibility on the second group of issues above will support U.S. efforts to maintain its leadership and credibility on the long-term objectives.

4. In making our individual decisions, we should be aware of the following upcoming events:

-- July 15	GATT Subsidies Code discussion of U.S. steel findings
-- July 21 - 22	OECD Steel Committee meeting
-- July 22	Possible Polish announcement of domestic policy changes
-- August 14	U.S. extension of pipeline sanctions takes effect
-- August 24	Deadline for final ruling by Commerce Department on steel CVD cases
-- September 6-9	IMF/World Bank meetings on economic policy consultations and intervention study
-- September 30	Expiration of U.S.-USSR grain agreement
-- November	GATT Ministerial
-- December	NATO Ministerial

STEEL TRADE TENSIONS BETWEEN THE U.S. AND THE EUROPEAN COMMUNITIES

ISSUE

U.S. unfair trade statutes require the imposition of special duties on imports benefitting from subsidies or dumping (sales below fair value) and causing injury to a U.S. industry. On June 10, the Commerce Department issued a preliminary determination that certain major steel producers in France, Belgium, Italy, and the U.K. receive subsidies ranging from 18-40% of the value of production.

Imposition of the duties, which would equal the level of subsidization, would effectively exclude those producers from important sectors of the U.S. market. At the same time, the Commerce Department found that major producers in West Germany and the Netherlands do not receive significant subsidies. While those producers (and their governments) are pleased at our preliminary determinations, they fear that their own markets could be severely disrupted by steel coming from the countries effectively excluded from the U.S. market. The importance of the steel industries in the countries named means that the European Communities (EC) must consider the U.S. action as a major trade irritation, even though the existence of the subsidies was widely acknowledged, and the U.S. action is both required by our law and clearly permitted by the GATT international agreement allowing countervailing duties.

At the same time, failure by the Administration to enforce our statutes and our rights under the GATT agreements could lead to domestic pressures for extreme protectionist measures by the U.S.

In accordance with Administration policy, Secretary Baldrige left for Europe on July 7 to resume intensive efforts to find a solution acceptable to all sides that will enable us to settle these cases prior to October 8, (the date by which, under the statute, final determinations in the subsidy cases must be made by the International Trade Commission). Preliminary determinations are due August 9 in dumping cases covering the same EC countries and products. These determinations may heighten the existing tensions. Any settlement must relieve the U.S. industry of injury caused by the subsidized or dumped imports, while still providing a trade regime that will not totally eliminate major segments of U.S.-EC trade in steel.

BACKGROUND

The world steel industry has been in crisis since 1975 as a result of growing structural imbalance between supply and demand as well as recurrent cyclical downturns. The industry in many EC

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countries has adjusted poorly, relying on increasing government financial assistance rather than closing excess inefficient capacity and reducing its excess labor force. The West German steel makers' trade association estimates that $30-35 billion has been spent or is already committed by governments of other EC countries for steel for the period 1975-83. In the last two months alone, the French Government has proposed about $4 billion in additional subsidies, leaving the Dutch and German steelmakers to seek help from their governments in order to modernize and stay competitive with their heavily subsidized neighbors.

The current recession in Western Europe has hit steel quite hard, with production levels down 3.9% in May 1982 from last year's low level, and capacity utilization down to below 65%, while imports (i.e., from outside of the EC) now take 10% of the market (up from 7% in 1981).

The EC approach to the current steel crisis has been to raise internal prices through coordinated cutbacks in production. For the third quarter of this year, production is scheduled to be reduced by 40%, while steel industry employment has continued to decline and alternative employment is scarce at a time of extremely high unemployment for Europe (over 9%). As a result, continued steel subsidization has become a political necessity for several governments, either out of desperation (Belgium), as part of national economic programs (France and Italy), or to keep a nationalized steel company going while reducing it down to a rational size (Great Britain). Nevertheless, the EC member states recognize the need to eliminate obsolete and excess capacity, and to create an industry that can compete without government assistance. The EC as a whole is committed to a State Aids Code in steel designed to eliminate both excess capacity and subsidization by the end of 1985.

While exports from the countries likely to be excluded by the cases only amount to about 2% of those countries' steel shipments, the loss or redirection to internal markets in the EC of this production would exacerbate steel-related economic and political difficulties, especially in Belgium and France.

The U.S. industry has adjusted somewhat better than the European industry, by closing obsolete plants, reducing its labor force, and investing in modern equipment when funds are available. High import levels can harm the U.S. industry, not only by depriving it of sales, but also because the low price levels caused in part by imports have prevented the industry from obtaining the capital (either through retained earnings, or outside financing) necessary for modernization. Since November 1980, the U.S. steel industry, relying on the Administration's economic recovery program has announced $6.6 billion in new capital investment, but in recent months a number of those projects have been put on "hold" as a result of declining demand, low prices, and high levels of imports.

The U.S. industry's capacity utilization, which averaged 77.7% in 1981, dropped below 50% by May 15 of this year, and has not gone above 50% since. Many of the major steel producers will lose significant sums of money this year, and one is reported to be approaching bankruptcy. Over 135,000 steel workers are laid off or on short-time (31% of the industry). Imports have reached 24% of consumption. While imports are not the sole problem for the industry, failure to address the trade problem vigorously would have serious political consequences for the Administration.

The U.S. industry in 1977 and in 1980 sought to have the U.S. government enforce the unfair trade laws. The U.S. government, wishing to avoid a dispute with the Europeans, sought to buy time for the Europeans to move their industry on to a sound commercial footing so that the EC industry might compete internationally without dumping or subsidization. Both times, the Carter Administration persuaded the U.S. industry to withdraw its complaints, first by establishing the trigger price mechanism (TPM) in 1977, and then by strengthening TPM in 1980, to run for five years. The maintenance of the TPM through 1985 was intended to protect certain European producers from countervailing duty (and possibly antidumping) complaints. Nevertheless, some of the European producers openly (or through evasion) undercut the trigger prices in 1981 and rapidly expanded their sales while the demand in the U.S. market declined substantially. Because the European producers violated the TPM, the American industry now doubts the good faith and reliability both of the European producers and the EC Commission. They will insist that any settlement guarantee that they not be deceived again.

OTHER EAST-WEST ISSUES - CREDITS AND COCOM

Credits

1. Continue our pre-summit efforts to persuade Allies to restrain credits to the USSR:

2. Concentrate in the short term on exchanging information on credits; move in a few months to a monitoring mechanism and only later to another try at actual controls.

3. Drop attempt at restraining credit.

COCOM

1. Continue our efforts to tighten COCOM controls and improve enforcememt

OPTIONS ON US-SOVIET GRAINS AGREEMENT (LTA)

1. Do nothing, allow LTA to lapse.

2. Extend the LTA for one year on its present terms;

3. Explore the possibility of negotiating a new LTA with different terms.

AGRICULTURE

ISSUE

EC agricultural policies represent the single greatest distortion of world agricultural trade. Efforts by the United States and other principal agricultural trading countries to moderate the negative impact of EC policies have been unsuccessful. The EC has continued unwarranted increases in its intervention in support of its farmers. Although the direct cost of the price supports have been borne by EC taxpayers, U.S. farmers have paid the indirect costs through lost export sales and lower world prices; U.S. taxpayers have paid through higher cost farm programs.

The farm community believes that a more competitive footing for U.S. exports must be established either through direct U.S. Government assistance or by eliminating the unfair advantages provided by the EC to its producers. In the last year, the United States has introduced a series of complaints to the General Agreement on Tariffs and Trade (GATT) on separate EC practices.

The EC has maintained that the U.S. actions are an attack on the CAP and a threat to its sovereignty. The EC points to the U.S. bilateral trade surplus with the EC in agriculture as an indication of the openness of the EC market. (In the past, the United States was able to obtain several key agricultural concessions from the EC including duty-free entry for soybeans and certain feed grains.) It points to distortions caused by U.S. agricultural policies such as our marketing orders for fruits and vegetables, our price supports and our import quotas, particularly on dairy and sugar.

Because the GATT rules on agricultural subsidies are ineffective, the U.S. Government may lose some of its GATT cases against the EC. At the November 23-26 GATT Ministerial, the Government intends to seek a commitment to tougher rules on agricultural subsidies. The EC realizes that it will be the target of these rules and is wary of the commitment.

BACKGROUND

The CAP has enabled the EC not only to achieve self-sufficiency in many commodities but also to produce surpluses which can only be disposed of by government-subsidized sales to third countries. Inside the EC, the CAP is viewed as a success. It has protected farm income and helped the EC to achieve self-sufficiency in many products. Outside the EC, however, the effects of EC policies are looked upon as a major distortion of normal competitive trade development, both in the EC market and in third-country markets.

The United States and other major agricultural countries have, for the most part, refrained from defending their interests too forcefully, in the interest of preserving European unity. However, in recent years it has become clear that the CAP has permitted production of many products to reach proportions that can be managed only by shifting the cost to other countries. This is accomplished by insulating the EC farmer from price fluctuations with tight import protection, encouraging him to overproduce through high guaranteed support prices, and pouring the resulting overproduction onto the world market with export subsidies, regardless of the existing price situation in the world market.

The Administration, following consultations with leaders of Congress and the farm community, has decided to defend its interests where EC practices are hurting U.S. trade and, therefore, the domestic economy. U.S. farm income in real terms is at its lowest point since the depths of the great depression. Because of this situation, the Federal Government may find itself making huge financial outlays in deficiency payments and other aids to farmers. At least a portion of these difficulties find their root in the domestic support and export subsidy programs of the EC.

In the early 1970's the EC was considerably less than self-sufficient in several important agricultural commodities including wheat and wheat flour, beef and veal, poultry and sugar. By the mid-1970's, through the price support and income enhancement provisions of the CAP, the EC had achieved self-sufficiency in all of these commodities. But production increases did not stop there. In the 1970's and 1980's, surplus production has been dumped into world markets with the use of large export subsidies, in direct competition with the U.S. and other traditional export suppliers. (See figure 1.)

A recent analysis by USDA in conjunction with Michigan State University shows that, had the EC held wheat exports in 1981 at the previous year's level, they would have exported 7 MMT less. The U.S. could have exported 4.1 MMT more with an export value of $816 million (Canada 1 MMT, Australia 2MMT, and Argentina .1 MMT more), U.S. wheat producer's price would have been $.50 higher, U.S. GNP would have been $4.4 billion higher, federal tax revenue would have been $98 million greater and 16,000 jobs would have been created.

A large portion of EC agricultural exports are in the high value unprocessed, processed or semi-processed category and are exported through the use of producer, processing and export subsidies. U.S. agriculture is unable to compete in this high value market that is more stable and provides greater returns to the total economy per ton exported than do the lower value bulk commodities as long as the EC continues its subsidy policies. In 1970 the unit value of all U.S. agricultural exports was $170 per ton; by 1980 this unit value was $265 per ton. During the same period the unit value of EC agricultural exports grew from about $400 per ton to $1225 per ton.

In the case of sugar, the Community's subsidies have contributed to depress world prices which have caused the United States to institute fees and quotas to protect our domestic producers.

We face heavily subsidized EC products in a number of markets. Their poultry competes with ours in the Middle East; their wheat flour takes markets all around the world; their beef exports depress prices in a number of markets; and their dairy exports are part of the justification for maintaining our own quotas on dairy imports. Since the adoption of a common agricultural policy, the EC has changed from a net importer to a net exporter of one key agricultural product after another with tremendous impact on world markets; this trend shows every sign of continuing. They have aggressively taken markets from our private sector with the use of the combined treasure's of ten Member States.

Over a period of years, we have attempted to work out our differences bilaterally, but the EC has told us repeatedly either that we are not being hurt or that it is the Community's right to subsidize and that we should not complain. Since our bilateral discussions have been unproductive, we have taken these differences to the dispute settlement mechanism of the GATT. Although some in the EC view this as a hostile act, we see it as using arbitration to defend our rights as a contracting party to the GATT.

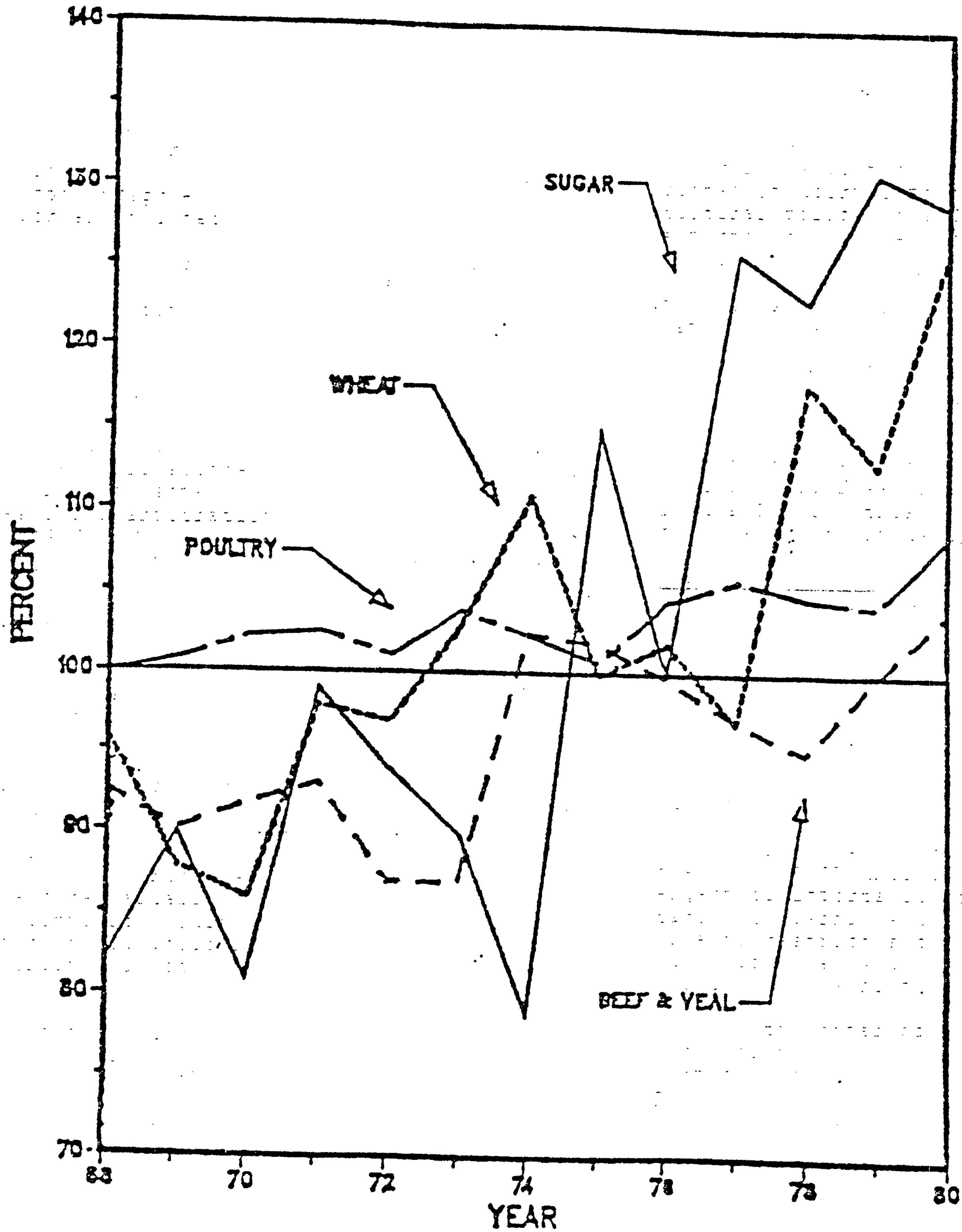
CURRENT SITUATION

The GATT cases now in progress are in each instance an attempt to pursue legitimate trade complaints. However, they also are a signal to the EC that the United States will no longer tolerate government-induced trade distortions. This is all the more crucial now that the EC is considering, for internal budgetary reasons, ways to "reform" the CAP. The United States is concerned that, among other things, some of the suggested reforms will solidify and institutionalize gains in EC exports to third country markets brought about by subsidies.

On June 24, we received formal notification from the EC that they want GATT Article 22 consultations to discuss the "disruptive effect of imports of corn gluten feed," one of the more valuable tariff concessions that we have with the EC. The Community would like to restrict such imports. To ease our pressure on EC agricultural policies would encourage the EC to seek restraints on other valuable concessions.

On the other hand, we need to find ways to strengthen the hands of those in the EC (especially the British, Dutch and Germans) who share many of our concerns and are seeking ways of making the CAP more rational. We have, in fact, been encouraged by officials in these Governments and by the Budget and External Affairs Directorate of the Commission to persevere in our efforts as the only way to bring about effective change in Community unfair trade practices.

EC SELF-SUFFICIENCY IN SELECTED COMMODITIES



U.S.- U.S.S.R. GRAIN AGREEMENT

ISSUE

The EC is extremely critical of the U.S. grain sales to the U.S.S.R. while this country presses for cooperation on trade sanctions against the Soviets. The current U.S.-U.S.S.R. Grain Agreement will expire on September 30, 1982 and the Administration must decide soon whether to negotiate a new agreement, extend the current one, or allow it to expire.

I. BACKGROUND

Soviet food policy shifted in the early 1970's from one of living with wide variation in grain supplies and slow growth in production of livestock products to one of raising the trend in livestock output and using grain imports to balance surges and shortfalls in production. The first indication of the new policy came in 1972 when the Soviets purchased 19 million tons of grain in U.S. markets within 3 months. In the wake of continued volatile and largely unpredictable purchases from the U.S., the Ford Administration suspended sales in 1975 until the U.S.-U.S.S.R. long-term grain agreement (LTG) was negotiated. The agreement required minimum Soviet purchases (6 mmt) and allowed them to purchase 2 million additional tons without consultation. The purchases were to be evenly spaced over the year. Purchases above 8 million tons could be made only after consultations with U.S. officials. During 1976-79, when the agreement was in force and before the January 1980 embargo, grain sales were less volatile than previously and the U.S. share of the Soviet market increased. Although the embargo was lifted in April 1981, the Soviets have only purchased U.S. grain residually to other supplies, notably from Argentina, Australia, and Canada. This pattern has been reinforced by the postponement of negotiations on a new agreement in the aftermath of the Polish Declaration of Martial Law. As a result, the U.S. has slipped from supplying a peak of over 70 percent of U.S.S.R. grain imports to around 40 percent. Only a fourth consecutive poor U.S.S.R. crop will prevent the U.S. share from declining even further in 1982/83.

II. DISCUSSION

Soviet Requirements. The U.S.S.R. has imported over 100 mmt of grain since June 1979, and will likely import another 40-45 mmt by July 1983. It now appears that the volatility in grain import requirements is being compounded by chronic failure to meet long term output goals. Total Soviet imports of food items, including e.g., meat, dairy products, sugar, vegetable oil, etc., account for 40 percent of all hard currency imports. In 1982, the total bill for agricultural products will likely increase by $1 billion up to $12 billion, but the total will depend on several policy and production related factors.

The Soviets are committed to ambitious food goals through the 1980's, with the intent of relying more heavily on domestic production. Although they have indicated a shift to decreased reliance on capitalist countries as a food source, the consumption goals will be difficult to meet without large-scale imports from the West.

World Grain Trade. The U.S.-U.S.S.R. Agreement is expected to have little impact on grain trading patterns in the next year. In the longer term, however, the lack of an agreement would remove the minimum levels of Soviet purchases from the U.S. Without an LTG, other exporters would likely continue their recent pattern of production expansion, to the detriment of U.S. market share in the U.S.S.R. Since 1980, Argentina and Canada have increased production by roughly 25 percent. Even larger supplies in the future will mean increased competition for non-Soviet grain trade as well.

U.S. Foreign Policy Considerations. The U.S. is pursuing, and encouraging its allies to pursue, a general policy of economic restraint with the U.S.S.R., based upon fair burden sharing in the West. A government-to-government agreement, especially one perceived as newly-negotiated, that promotes grain exports, would be regarded as an exception to that policy. It would provide Moscow with partial insurance against any future changes in grain export policy.

More specifically, negotiations with the Soviets would signal an end to one of the President's measures against the U.S.S.R. in response to the Poland crisis, undercutting the general package of Poland-related sanctions, and implying that the situation there has improved and that the U.S is prepared to adopt a "business as usual" stance. The Soviets could be expected to promote this interpretation vigorously.

Resuming negotiations would conflict with the decision to extend extraterritorially sanctions on oil and gas equipment and technology. In the absence of real changes in Poland, resuming negotiations would undermine U.S. credibility on burden sharing and U.S. efforts to induce its allies to exercise restraint in credit and trade arrangements with the U.S.S.R.

The EEC heavily criticizes the U.S. for continuing the Grain Agreement while we request them to undertake sanctions against the Soviets. Allowing the Agreement to expire, however, is unlikely to change the Europeans' attitudes. They will see our demand for additional sanctions as unreasonable regardless of the status of the Agreement. Furthermore, even without an agreement, the Soviets are likely to continue purchasing considerable amounts of U.S. grain (at least in the next year); thus, the Europeans would accuse the U.S. of undertaking no real hardship in the near term by letting the Agreement expire. Furthermore, the Europeans seem to use the Agreement as an argumentative point and care little about the substance of grain sales.

Renegotiation of the Agreement, however, (or extension of an amended agreement with a larger minimum) might cause even more rhetoric from the Europeans. They might also refuse to undertake any further sanctions and could even reverse those already imposed.

In the absence of an agreement, the U.S. would have to take drastic action under the Export Administration Act to limit Soviet purchases from the U.S. either through export controls on all foreign customers (because of severe domestic shortages) or through use of the national security and foreign policy provisions of the Act. Thus, continuation of the current agreement would be more effective in regulating U.S.-U.S.S.R. grain trade than letting the agreement expire. Some analysts believe that a new agreement would increase Soviet vulnerability to a new embargo.

On the domestic front, the U.S. farm sector is experiencing serious economic hardships in the face of record grain supplies and low prices, as well as high interest costs and continuing increases in the prices of production items. Relieving these burdens on farmers will require continuation and possibly expansion of farm programs which will require additional budget outlays. The negotiation of a new agreement that guarantees a larger share of the Soviet market for U.S. farmers is virtually the only cost-free, market-oriented step the Adminstration can take to help the farm community. It is also consistent with the central feature of the Administration's farm policy--increasing agricultural exports. Farmers will regard the decision on the agreement as a test of Administration commitment to agriculture. The U.S. maritime industry also has an interest in a new agreement in order to preserve a share of the U.S.-Soviet grain trade for U.S. shipping.

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Note: USDA has recorded its objection to paragraphs 2 and 3 under the section entitled U.S. Foreign Policy Considerations on the preceding page and to the final sentence of paragraph 2 on this page.

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EXTENSION OF DECEMBER 29, 1981 SANCTIONS ON OIL AND GAS EQUIPMENT TO THE U.S.S.R. AND IMPACT ON POLITICAL AND TRADE RELATIONS WITH EUROPE

ISSUE

The President's decision to extend the December 29 sanctions to include equipment produced by subsidiaries of U.S. companies abroad as well as equipment produced abroad under licenses issued by U.S. companies, has resulted in serious strains in political and trade relations between the U.S. and several EC members, notably France, Germany, the U.K. and Italy. Japan's reaction to the decision is considerably less critical due to the production phase of the Sakhalin project having already been postponed, together with assurances given by the Soviets that the 1975 General Agreement governing the project would remain in force.

BACKGROUND

On June 18, 1982, President Reagan announced his decision to extend foreign policy controls on exports of oil and gas equipment and technical data to the U.S.S.R. to include products manufactured abroad by U.S.-owned or controlled companies or by foreign firms under U.S. licenses. Pre-June 18, 1982 controls restricted exports and re-exports of U.S. origin and gas goods and technical data for all phases of the U.S.S.R. oil and gas industry (exploration, production, transmission and refining). The controls on transmission and refining equipment were imposed on December 30, 1981, as a result of Soviet-sponsored repression in Poland. Controls on exploration and production were first imposed in July 1978 in response to harsh treatment of Soviet dissidents and the arrest of an American businessman. In addition, all licensing of high technology items to the U.S.S.R. was suspended by the December 30, 1981 decision.

The actions of June 18 were necessary because of serious U.S. concern over the continued lack of reconcilation in Poland, and continued U.S. opposition to the Trans-Siberian natural gas pipeline. In the past six months there has been little moderation of the repression in Poland.

The President's decision to amend oil and gas controls will increase the cost of the pipeline, and delay its construction. Assuming our friends and allies do not transgress our regulations, the Soviets are faced with several options: use smaller turbines from Switzerland and other sources, employ electric motors instead of gas turbines to power the compressors, or produce their own gas turbines. All of the options will significantly delay pipeline construction, raise the costs to the Soviets, and affect the efficiency and reliability of the pipeline.

European Reactions. As anticipated, our European and Japanese allies have reacted sharply to the expanded sanctions. Their reactions, thus far, have been rhetorical, however. They have not taken any concrete measures, e.g., court action or blocking legislation.

The FRG has voiced criticism, using ~~statements~~ statements like "economic cold war", claiming that the U.S. decision went contrary to understandings reached during President Regan's visit to Bonn and to agreements made at Versailles. The French followed with equally hostile accusations and expressed fear for the weakening of the Western Alliance. Italian officials have also expressed concern over the expansion of the sanctions, claiming that the U.S. action would hurt Western European companies more than the U.S.S.R. The European Community issued a statement, following a late June summit meeting, criticizing the expansion of the sanctions. The EC claimed that the U.S. action, taken without consultation with the Community, is contrary to principles of international law, unacceptable to the Community, and unlikely to be recognized in EC courts. (This criticism is somewhat unwarranted since consultations have been ongoing since the imposition of sanctions in December 1981.) The Community also called for a dialogue at the highest levels to find solutions to a range of contentious trade issues ranging from steel to agriculture.

The U.K. has issued an order invoking the Protection of Trading Interests Act (PTI) of 1980, asserting that the U.S. controls are damaging to British trading interests. The order, thus far, does not carry substantive actions. The British can take additional measures to: (1) require U.K. firms not to provide information to the USG or (2) prohibit them from complying with U.S. regulations. British officials stressed that the U.K. wants to avert confrontation with the U.S. on this issue. Other countries might follow the precedent in an export controls conflict fifteen years ago when a French court put a receiver in charge of a U.S. subsidary to compel shipments to China barred by U.S. controls.

(A State Department paper, "Poland and Economic Sanctions: Managing These Issues with the Allies, Poles, Soviets, and Domestically," which discusses this issue, among others, at greater length is attached. Also attached is a paper, "Energy Alternatives," which discusses the U.S. effort, currently under the guidance of an interagency group headed by Under Secretary Buckley, to develop other energy sources in the West as alternatives to gas from the Siberian pipeline.)

Economic Costs. The President's decision to expand controls on oil and gas equipment and technology can result in a noticeable economic loss to U.S. firms and U.S. foreign subsidiaries and licensees. It is estimated that U.S.-based company export losses from the December 30 sanctions could range from \$300 - \$600 million over the next three years. U.S.-owned or controlled companies abroad could lose, as a result of the June 18 decision to extend controls, an additional \$600 million over the next three years, while foreign firms which are licensees of U.S. technology stand to lose over \$1 billion over the next three years.

Besides the estimated short-term costs to U.S. companies and their foreign subsidiaries there can be a diminution of the U.S. reputation as a reliable supplier of equipment and technology and as a dependable commercial partner.

There exist about 40 U.S. companies with subsidiaries that have been brought under the export control umbrella as a result of the June 18 actions. The major ones are (country in parenthesis indicates where subsidiary is located): ARMCO (Brazil), Baker (U.K.), Camco (U.K.), Cameron Iron Works (France), Control Data (France), Dresser (Canada, France), FMC (France), Grove Valve and Regulator (Italy), Honeywell Control and Measuring Devices (Austria), Howmet Turbine Components (U.K., France), and Rockwell International (Netherlands).

In addition there exist at least an equal number of foreign firms that depend on U.S. technology to manufacture oil and gas equipment. The significant ones include: Alsthom-Atlantique (France, GE licensee), John Brown (U.K., GE licensee), AEG Kanis (FRG, GE licensee), Nuovo Pignone (Italy, GE licensee), Mitsubishi (Japan, TRW licensee), and Hitachi (Japan, GE licensee).

Legal Implications. To date, we know of no violations of the U.S. controls. Any creditable investigative leads concerning questioned controls would, of course, be vigorously investigated by the Commerce Department Office of Export Enforcement. If, as a result of such an investigation, a violation were found to have occurred, appropriate administrative and/or criminal sanctions would be pursued, depending on the circumstances underlying the violation(s), i.e., the technology and products involved, the scope and nature of the facts constituting the alleged violation(s), the strength and availability of competent evidence of the alleged offense, and the equity considerations in the case. We have a broad range of administrative and criminal sanctions available against any violations:

Administrative Sanctions -- Formal administrative proceedings can be initiated which could result in: (1) the imposition of a civil penalty of up to $10,000 per violation for violations of the foreign policy controls; (2) suspension or revocation of existing export licenses; and/or (3) partial or total denial of U.S. export privileges for a specified period of time.

Criminal Sanctions -- Criminal charges would also be considered for violations of the controls. Any foreign company official individually charged may be arrested if he enters the United States. He may also be arrested on the basis of probable cause. Anyone who knowingly violates any of the controls is subject to a fine of five times the value of the exports or $50,000, whichever is greater, or to a five year prison term, or both. Willful violations of the new controls on the part of a company could result in the firm's being fined five times the value of the export involved or one million dollars, whichever is greater. Individuals who willfully violate the controls may be fined up to $250,000 or sentenced to a prison term of up to ten years, or both for each violation.

Poland and Economic Sanctions: Managing These Issues with the Allies, Poles, Soviets and Domestically

BACKGROUND

The combination of mounting Allied resentment over the President's June 18 sanctions decision, hints that significant moves by the Polish regime toward relaxing martial law may be announced July 22, and a delicate negotiation between the Pope and the Polish regime regarding his proposed visit to Poland in August make it essential that we focus on the sanctions issue. How we manage this issue over the next month will have very broad implications, since we have linked other questions, such as this fall's CSCE meeting in Madrid and sanctions on oil and gas equipment, to developments in Poland. The manner in which we handle the increasingly pressing question of Polish debt will also have ramifications far beyond Poland itself given the manifold uncertainties currently at play on the international financial markets.

Impact of the Sanctions Decision. How our European friends plan to play this issue remains a matter of conjecture. To a degree, the decision rests with the Soviets, who can decide whether or not to insist that the contracts, which cannot now be fulfilled under US regulations, be met by the three European turbine manufacturers. The Soviets could, by calling the Europeans for non-performances, cancelling the contracts, and invoking penalty clauses, remove a certain element of urgency from our consideration of the issue, although the resulting bankruptcies and additional unemployment in Western Europe would further sour Atlantic relations for some time to come. This could also be the source of legal challenges to the President's decision both here and in Europe. Given the uncertainties involved, the legal route does not offer an attractive means to resolve this dispute from our point of view. For our Allies, this route appears much too time-consuming as far as the case at hand is concerned.

Unless the Soviets move quickly to invoke penalty clauses and/or cancel their contracts, we estimate that the Europeans will make yet another effort, individually at first and perhaps then collectively, to persuade the President to reverse his decision. If they follow this course of action, we will have a certain element of leverage over them. The question which then arises is what we should seek to persuade them to do, the two obvious alternatives being further steps regarding credits and actions in the Polish context.

Possible Linkage with Credits. One reason for European unhappiness with the June 18 decision is their claim, which can only be based on a misreading of the situation, that the understanding reached at Versailles on future credits to the Soviet Union presupposed a decision by the President to permit the execution of contracts in existence at the time of his original December 30 sanctions decision. The President's reaction to the agreement reached at Versailles makes clear that lacking a strong credits arrangement he felt he should extend the sanctions and link the extension to continuation of the situation in Poland. Obviously, further Allied action to restrict official credits and credit guarantees to the Soviet Union is a highly desirable objective. We must recognize, however, that there is very little possibility with a continuation of the sanctions that the Allies, in particular the French, will go beyond (a) the very limited agreement at Versailles (or even effectively implement it) or (b) the June 30 agreement to revise the OECD export credit consensus arrangement, which has the effect of pushing the minimum lending rate for credits to the Soviet Union up from 10.5 percent to 12.15 percent. We should further recognize that even were the Allies willing to do significantly more on the credits front, it is not clear that this would satisfy the President's requirements, which are explicitly tied to Poland; to mislead them on this score would be irresponsible. This leads us back to the situation in Poland and the inescapable fact that, at least in the short run, absent an extremely unpromising effort to put together a credits-for-sanctions package, movement on the sanctions depends on developments in Poland.

Situation in Poland. At this point, the outlook for movement in Poland toward satisfying the three Allied conditions (end of martial law, release of detainees and resumption of "genuine" dialogue with Solidarity) is uncertain at best. Clearly, a major struggle is underway within the Polish leadership regarding what measures, if any, should be taken in connection with the July 22 National Day toward satisfying these conditions. From the beginning, US and Alliance policy has been that sanctions are reversible provided the conditions are met. One thing which is almost certain, however, is that whatever emerges on July 22 will be less than full satisfaction of the three conditions, posing in a particularly difficult way the question which we have not yet been unable to answer of "how much is enough" to remove some, or all, of the sanctions. The Pope's proposed visit to Poland in connection with the 600th Anniversary of the Madonna of Czestochowa is another factor putting pressure on the Polish leadership to relax martial law and its attendant restrictions. Opposition to the Papal visit, notably from

Moscow, dramatizes the link between this event and the internal situation in Poland.

Allied Attitudes. Our Allies are anxiously awaiting any move by the Polish authorities which can serve as a basis for relaxing, and if possible removing, both the political and economic sanctions which they adopted following the December 13 imposition of martial law. The Allies are not united on which sanctions to relax or on the degree of urgency; they expect a sober and restrained approach and hard bargining with us. Nonetheless, the urge to relax sanctions if the Polish authorities move is general. On the political side this relates primarily to how the West will handle the resumption of the Madrid CSCE Review Conference on November 9 and the possibility of enhanced contacts with the Warsaw regime. None of the Europeans belive the resumed conference can or should be devoted exclusively to Poland, as the last session was, and the search is on for ways to open out the agenda; the Swiss are peddling the concept of private US-Soviet contacts to turn the key. On high-level contacts with the Polish government, these have been sporadic since December 13 (Schmidt, for example, met with Foreign Minister Czyrek June 14 in New York). Our Allies see some benefit in an enchanced political dialogue with Warsaw.

On the economic front, the Allies are clearly anxious to remove some or all of their remaining sanctions, particularly in the critically important area of debt rescheduling and new credits. Although there is little or no enthusiasm in Western Europe for assistance to Poland, per se, aside from an impressive humanitarian effort centering in Germany, there is substantial support for debt rescheduling and perhaps the provision in that context of limited new assistance to Poland (particularly for spare parts and industrial raw materials needed for exports), which would, in turn, make it possible for the Poles to service, even in a symbolic way, their rescheduled debts. The Europeans are distinctly unenthusiastic, given the mounting pressures on the international financial markets, about encountering the uncertainties which default on Poland's $27 billion foreign debt would entail. Even the most exposed European banks (Dresdner, BFGW and Credit Anstalt-Bankverein) could absorb a Polish default, but the Europeans fear the ripple effect of a default, not without reason. Unless the Europeans decide to go it alone, any movement on rescheduling would depend upon whether the US is willing.

Taking all these factors, including the European attitude, into account, our key objectives will be to: (a) join with our Allies in exerting maximum pressure on the Poles, and the Soviets, prior to July 22 to satisfy the three conditions; and (b) avoid a situation in which we and our Allies argue about whether moves taken by the Poles to relax the December 13 measures are "enough" to justify corresponding moves by the West and, if so, which measures would be appropriate on our side. Reaching agreement on this point will be extremely difficult, and the Poles (and Soviets) will doubtless do everything they can to use this issue to provoke additional disputes in the West.

ENERGY ALTERNATIVES

ISSUE

The United States has been and continues to be actively engaged in developing the abundant and economically attractive energy resources in the West as an alternative to increased imports of Soviet energy by Western Europe.

BACKGROUND

There are abundant and economically attractive energy resources within the Western community. The United States is striving for a new commitment with our European and Japanese economic partners to develop indigenous energy resources through greater reliance on market forces supplemented by government action when broader Western economic and security concerns are threatened.

Under Secretary Buckley has convened a high level interagency group to review these energy resources as alternatives to the Siberian pipeline and to determine what actions the United States can take to assist in their development. Ambassador Galbraith has been consulting with North Sea petroleum producers and European governments to determine what measures would be necessary to accelerate development of North Sea oil and gas that could minimize Western European dependence on Soviet energy. Some progress has been made. The Norwegian press has noted the energy security significance of North Sea petroleum for Western Europe. The Netherlands and Belgium have virtually withdrawn from the Siberian project, in favor of using more Dutch natural gas. New attention has been focussed on the regulatory and tax obstacles to North Sea hydrocarbon development. A U.S. mission has attracted new interest in U.S. energy exports to Western Europe.

While the promotion of alternatives to the Siberian pipeline is still an early stage, it is already receiving public attention in Western Europe and has resulted in the beginning of quiet discussions on the Continent.

OTHER EAST-WEST ISSUES

ISSUE

Although U.S. sanctions and the Siberian pipeline form the most contentious East-West economic issue dividing us and our Western allies, there are others on which differences have arisen, or may potentially develop. These include: (1) the U.S. initiative to obtain agreement on restraints on officially-backed credits to the Soviet Union; (2) rescheduling of Poland's debt; and (3) strengthening COCOM.

BACKGROUND

There is a gap between some elements of the U.S. approach to East-West economic relations and that of our West European allies. The decision to extend and expand sanctions did not create this gap; it did make it clearer. Our long-range objective is to develop a common approach which will reinforce Allied solidarity. In the short run, we must overcome the divisions within the alliance, thus denying the Soviets an opportunity to pry it further apart.

There are are three general attitudes that can be adopted towards the question of East-West trade and financial relations. First, one could make the case that any economic relations between Western countries and Communist countries are inevitably of greater benefit to the latter than to the former. This is principally based on two arguments. One is that trade and finance are much more important to the Communists, given the manifest failures and inefficiencies of their economic system. Another is that, on the Communist side, trade is conducted by and through state trading combines, which are able to play Western firms off against each other because of their monopoly seller or monopsony buyer position and obtain below-market terms and conditions.

Our problems with the Europeans arise in part from the different choices we have made between the other two alternatives. The position of the European countries by and large is that economic relations between Western and Communist countries serve to tie the latter to the former, at least to some degree, and thus provide a moderating element to the calculations of the Soviet Bloc. The very dependence of the Bloc on foreign economic relations to keep its economy going is a guarantee that it will be loath to disturb those arrangements. In any case, massive Soviet orders keep factories operating and save jobs, and it would be masochistic to reject them. Additionally, Soviet exports are made up largely of raw materials which the Western countries need. Using Soviet sources diversifies supply and adds to international competition, thus moderating prices. (This was also the economic reasoning underlying the policy of detente.)

While recognizing some merit in the first position and the logical and political attractiveness of the second, the Reagan Administration has adopted an intermediate attitude towards East-West economic relations. Detente has not, in fact, had the hoped-for effects. The Soviet military buildup and foreign adventurism have not moderated -- indeed they have greatly increased. On the other hand, the first attitude underestimates the bargaining ability of the Western corporate trading companies. Thus, trade and finance carried on in commercial terms and following commercial considerations are of approximately equal benefit to both sides and should be encouraged to the same extent that all external commercial relations are encouraged, so long as the terms and conditions of these relations are not skewed by official guarantees and/or subsidized interest rates. It is ridiculous that Western taxpayers are forced to pay for East-West trade on terms disadvantageous to the West, which adds net resources to the Soviet Bloc, enabling it to accelerate its military buildup and foreign adventurism.

There are two exceptions to this position: one is trade in military or dual-purpose equipment or technology and the other is when egregious begavior on the part of the Bloc, such as the imposition of martial law in Poland leads to the imposition of economic sanctions. It is the U.S. Government's application of these exceptions that has generated problems with the Europeans over the three issues discussed below.

Restraints on Credit to the Soviet Union. The prospects for the U.S. initiative for restraints by Western governments on credits to the Soviet Union are uncertain. As developed and discussed with the Europeans, our proposal was for an agreement to restrict officially-backed credits to the Soviets. Our analysis of the Soviets' economic and financial prospects indicated that they would need to borrow substantial amounts from the West to finance their import needs, and could thus build up a substantial debt. A principal rationale for a credit restraint agreement was that it would forestall this build-up and thus deny the Soviets the reverse leverage it would entail. We also hoped to make their resouce allocation decisions more difficult at the margin.

In a series of meetings from mid-March to the Versailles Summit in early June, Under Secretary Buckley and other high-level U.S. officials tried to persuade the Europeans to join us in a credit restraint agreement. Ultimately, we were unsuccessful. However, we did get communique language and a periodic review procedure that could enable us to continue to press the point with the Europeans.

Soon after the Summit, we began to lay the groundwork for the post-Summit phase of our effort. Concentrating first on improving collection of data on financial flows, we have raised the possibility of bolstering NATO's system and are making a similar pitch in the OECD. Some European officials, professing to be outraged over our extension of our export controls, have said that all Summit agreements for follow-up action are no longer valid. It is too early to predict what will happen, but such attitudes could jeopardize our effort to get improvements in data collection in this area as well as in any future monitoring proposal.

Eastern European Debt. The Polish and Eastern European debt situation, which had reached serious proportions by the latter part of 1981, took on an air of crisis when the Poles imposed martial law on December 13, 1981. In reaction to the Polish crackdown, the United States and its allies agreed not to reschedule Poland's 1982 maturities until martial law had been lifted; the political prisoners were released; and a dialogue was resumed among the government, the Church, and Solidarity.

Some Europeans, especially the Germans and British, are now showing signs of wanting to walk away from those conditions and reschedule the Polish debt. However, this has not yet become a major point of difference between us.

The Polish crisis exacerbated the difficult financial situation which other Eastern European countries were already experiencing. It made explicitly clear the falsehood of the "umbrella theory" and caused a further reduction in banks' lending to Eastern Europe.

These countries' debt situations have been dealt with through existing institutions and have not become a major source of contention among the Allies. Romania has reached agreement with the IMF for a one-year standby program, and a Paris Club rescheduling is getting underway; Hungary, which recently joined the IMF, may seek a standby this fall and in the interim is using the Bank for International Settlements (BIS) to raise funds to augment its reserves. Yugoslavia (not a member of the Warsaw Pact), which got caught in the backlash of this situation, also has an IMF program underway.

COCOM. A major effort in the direction of reducing the flow of Western technology to the U.S.S.R. that strengthens its war-making capabilities, was taken last January at the COCOM high-level meeting (HLM). The HLM provided the political guidance and philosophical umbrella needed to revitalize COCOM and strengthen multilateral controls on strategic trade. The United States now faces the task of negotiating and implementing the decisions taken at the HLM. This will require a major bilateral and multilateral effort if the United States is to be successful in restructuring COCOM.

U.S. goals for the HLM, considering the fact that it was the first political level meeting of the group in over 25 years, were largely achieved. The members basically reached a political agreement to:

1. Strengthen controls, placing more emphasis on controlling technologies and equipment critical to the Soviet military-industrial base, and decontrol less strategic items;

2. pursue a program of harmonizing national control systems, including licensing rules and procedures; and

3. strengthen the enforcement of controls world-wide.

Subsequent to the HLM the COCOM Subcommittee on Export Controls met in late May to consider the twin issues of improved enforcement and measures for harmonizing the licensing process. Although some forward process was achieved, it was less than anticipated. The HLM guidance did not prove completely adequate to achieve changes in direction or harmonization and enforcement but members agreed to continue examining the issues. The United States has submitted most of the technical proposals to restructure the COCOM List and will engage in negotiations starting this fall. The proposals followed the HLM guidance by strengthening technology while decontrolling nonstrategic items.

These proposals will not meet with ready acceptance by our Allies. However, we are proceeding in confidence that COCOM will work, provided that we are willing to limit its controls to military-related items.

MACROECONOMIC AND MONETARY ISSUES

ISSUE

There are four broad areas of tension between the U.S. and its major allies on macroeconomic and monetary issues:

1. Exchange market intervention policy
2. U.S. economic policy mix (mostly the budget)
3. High interest rates
4. The Japanese trade surplus

We have had extensive, very candid discussions with our European, Canadian, and Japanese counterparts on all these issues, and while we are obviously not in total agreement, there has been progress. The United States has developed well-reasoned substantive positions to address each of these, and steps are underway to deal with our differences.

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BACKGROUND

1. Exchange Market Intervention Policy

EC Position. Our allies (not just the EC) believe we should intervene more frequently in foreign exchange markets. Most of them believe that official intervention can help to dampen exchange rate volatility. At a minimum, foreign officials feel that intervention should not be renounced as a policy tool. In this regard, they were concerned that markets had misinterpreted current U.S. policy as one of total unwillingness to intervene under any circumstances. We have worked hard to dispel this impression during the past few months, through repeated private and public statements that while our policy is not to intervene under normal circumstances, we always stand ready to do so if necessary when markets are disorderly. The fact that we actually intervened on June 14, in the wake of the realignment of the European Monetary System (EMS) and widespread political uncertainties elsewhere, helped to lessen this source of tension with our allies.

Nonetheless, serious differences of opinion remain. Most of our allies would still prefer a more active U.S. intervention policy, and some would even like joint intervention to help peg exchange rate levels (especially the French).

U.S. Position and Rationale. Our policy is to intervene in foreign exchange markets only if necessary to counter disorderly markets. This policy is in full compliance with our obligations under the Articles of Agreement of the International Monetary Fund. In practice it has led us to intervene only twice since February, 1981. Under normal circumstances we believe that intervention is at best pointless, and perhaps even harmful, for three main reasons:

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-- Foreign exchange markets are large and efficient, and make full use of all available information in arriving at a collective "judgment" about where exchange rates should be. We do not believe any government or individual can second-guess the markets.

-- Intervention to fix or manage exchange rates has not succeeded in the past, and there is no reason to believe it would do so now. Market forces cannot be disguised for long. We should recall that frequent and massive intervention during the late 1970s did not keep rates from moving in the very directions that intervention was trying to avoid.

-- Because they believe they can buy time through intervention, governments sometimes delay needed domestic policy changes far too long. In addition, governments in strong economies which intervene against their own currencies may sacrifice domestic policy discipline and worsen their own inflation performance.

There is only one way to get fundamental stability in exchange markets, and that is through greater convergence in the domestic economic policies and performance of the major trading nations. As long as some countries have high inflation rates, and run generally unstable and undisciplined economic policies, there is simply no way to keep their currencies from depreciating relative to countries with stronger economies. Only when all are moving toward stable, non-inflationary economic policies and performance can we expect more stable exchange markets.

The EC is far from blameless in this matter. The French are the greatest critics of U.S. intervention policy, but the franc is a weak currency in the EMS principally as a result of Mitterrand government policies. Poor French inflation performance, policies and prospects have made the franc the weakest of the major European currencies. Other EC countries, like Italy and Belgium, have let their budgets go totally out of control. At times participants in the EMS have vainly tried to impose stable exchange rates among the EC currencies through intervention, while letting underlying economic policies and performance drift apart.

Not only have we taken great pains to overcome misconceptions about our intervention policy, but we have also set in motion two major procedural initiatives to help deal with the major issues. First, and in our view potentially most important, is the process of enhanced consultation on relative medium-term economic policies of the major countries, outlined in the Versailles Summit "Monetary Statement." In response to a U.S. initiative, the leaders of the major industrial countries agreed at Versailles that individual success in the fight against inflation is a precondition for a durable economic recovery. They recognized that exchange market stability stems from stable, non-inflationary domestic policies, and agreed to work together in cooperation with the International Monetary Fund to hasten the convergence of economic policies and performance among them. Preparatory work to establish procedures for this process is now underway, and we expect to have the first full meeting of the group at Ministerial level in September.

As a complement to this, the other major governments agreed just before the Summit to join us in a thorough multilateral study of the impact of past exchange market intervention. Preparations for this study are being worked out by an experts group, which met in mid-June in Paris and in early July here in Washington. Two additional meetings are scheduled for late July and early September. We expect a Ministers meeting in Toronto to approve a definite terms of reference and timetable for the study.

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2. U.S. Economic Policy Mix (Budget Deficit)

EC Position. At times, most foreign governments have complained that an alleged U.S. "policy mix" of tight monetary policy and loose fiscal policy is forcing our "real" interest rates (nominal interest rates adjusted for inflation expectations) to be unnecessarily high, which in turn forces their own interest rates up. Over time, most have realized that there is no acceptable alternative to a non-inflationary monetary policy, so the focus of their complaints has shifted to the U.S. budget. They argue that our current and prospective budget deficits are the major reason for our high real interest rates. They suggest that we should reverse or defer the scheduled tax cuts and slow the growth of military spending in order to reduce the deficit more rapidly.

U.S. Position and Rationale. While the budget deficit is a problem, the deficit in itself is not the only reason for high real interest rates. Our basic problems have been the lack of discipline in government spending and the variability of money growth. These two factors contribute to the lingering uncertainty that inflation will be kept under control (see also "High Interest Rates" below).

As a general matter, we believe that incentive-oriented tax rate reductions are an essential component of the President's program for sustainable non-inflationary economic recovery. Similarly, one of the government's primary responsibilities is to provide a strong national defense. While a number of factors are adding to the budget deficit, including the prolonged weakness of the economy, our unexpectedly rapid progress in cutting the inflation rate, and inadequate control of non-defense expenditures, the answer is not to change our basic tax and defense policies and abandon a stable policy course. Rather, we will be working aggressively with Congress to reduce the budget deficit in FY 1983 and beyond. The recent budget compromise is the first step in this process.

The most important thing we can do in this area, for domestic as well as international reasons, is to continue to press for expenditure restraint and less volatile money growth. In the mean-while, foreign officials will have a chance to review our efforts and discuss them with us in bilateral and multilateral consultations, especially the enhanced consultation process endorsed at Versailles.

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3. High Interest Rates

EC Position. Europeans believe that whatever the reason for unprecedentedly high "real" U.S. interest rates, there is no hope for vigorous economic recovery anywhere in the world until we get our interest rates down. They argue that because of the dominant role of the U.S. dollar in world financial markets, high U.S. real interest rates automatically push other countries' interest rates up as well. The result is worldwide economic stagnation and rising unemployment.

They would like for the United States to do "whatever it takes" to get our interest rates down. The most widespread prescription is that we should move faster to cut the projected government budget deficits (see "Policy Mix" above). Some also believe it would be possible to lower real interest rates by targeting monetary policy less on slowing the growth of the money supply, and more on stabilizing interest rates.

U.S. Position and Rationale. We, too, are being harmed by our high real interest rates. Our stake in getting them down is at least as great as that of any of our allies. U.S. interest rates are already well below their peaks, and we remain convinced that interest rates will come down further if we persevere in implementing the President's basic program for economic recovery. We are of course disappointed that it is taking so long to happen, and consider this the major short-term uncertainty in the economic outlook.

We should note, however, that interest rates are high abroad for domestic reasons, not just due to passive responses to high real interest rates in the United States. This is especially true of the unusually high rates now prevailing such countries as France, Italy, and Belgium as a result of their very poor inflation peformance and weak economic policies.

While it is difficult to explain fully the persistence of high U.S. interest rates in the face of our declining inflation rate, there seem to be a number of contributing factors. The budget deficit is clearly one of them -- particularly the uncertainty surrounding the impact of unrestrained government spending on the budget situation in future years. In addition, the Federal Reserve has had difficulty in keeping near its target growth path for the monetary aggregates, raising concern about the ultimate direction of monetary policy and thus of inflation. Market reactions to the volatility of money growth have added several percentage points to the level of interest rates.

We must continue our efforts on both of these fronts. We should keep up pressure on the Congress to enact the measures needed to bring government spending under control. We must certainly stick to the fight against inflation. While there has been a dramatic improvement in underlying U.S. inflation performance over the past year, inflation expectations are lagging behind because our citizens are not sure we can stick to our guns. The faster we can convince them that we are going to bring inflation permanently under control, the faster we can reduce the "uncertainty premium" in interest rates.

On the monetary policy front, we fully support the stated Federal Reserve policy of achieving a gradual reduction in the growth rate of the money supply. However, while the Fed has on balance given us slower money growth, the growth path has been erratic: performance has not matched intentions. As a result, interest rates have been much higher than would have been the case with steady, stable, and predictable money growth. We believe that a smooth and steady reduction in the growth rate of the money supply is essential to our efforts to reach a sustainable non-inflationary economic recovery. We know the Fed is sincere, and we are hoping that it will improve the implementation of monetary policy. One positive sign that the volatility of money growth might be reduced is the Fed's recent decision to approve in principle one of the technical changes this Administration has been urging them to adopt -- contemporaneous reserve accounting. While we believe that some other technical changes are also needed, this decision to shorten the lag in bank reporting to the Fed from two weeks to two days could help increase the Fed's ability to control the money supply.

Obviously the complaints by our allies, including the EC, about high U.S. real interest rates will persist until we are successful in bringing them down. Our best method of dealing with their complaints is to continue being candid with them about our own concerns on this score, to express sympathy for their difficulties, and to emphasize the measures we are taking to remedy the situation. Again, the Versailles Summit "consultation group" should provide a forum for thorough discussion which will help clear the air.

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4. <u>The Japanese Trade Surplus</u>

<u>EC Position</u>. There is concern, <u>both</u> in Europe and the U.S., over the growing Japanese trade surplus. The Japanese have become extremely successful competitors in a number of large and politically sensitive industries, including automobiles, electronic appliances, and semiconductors. Some observers have argued that the Japanese have "artificial" advantages, caused by relatively low Japanese interest rates and an "undervalued" yen exchange rate which makes their exports unreasonably cheap on foreign markets. Some believe that the Japanese should change their economic policy mix -- easing fiscal policy and tightening monetary policy (i.e. the reverse of what they want the U.S. to do). They argue that this would lead to both faster growth and higher interest rates in Japan -- and that these in turn would cause the yen to strengthen on exchange markets. Others believe that the Japanese should institute capital controls to strengthen the yen.

<u>U.S. Position and Rationale</u>. Japanese interest rates are low as a result of their consistently successful economic policies, and the good Japanese track record on inflation. We feel it would be highly inappropriate to press the Japanese to run bigger budget deficits at a time when their deficit is already quite large in terms of GNP. We have no evidence that the Japanese are artificially depressing the yen exchange rate. In fact, it is clear that Japanese

officials would like to see a stronger yen, but have not found an acceptable way of bringing this about. We have a long-standing objective of getting the Japanese to open their capital markets more to foreign participation -- a goal which is inconsistent with the imposition of new capital controls (and whose achievement might, at least in the short run, tend to put downward pressure on the yen). We should avoid becoming a party to proposals for new Japanese capital controls or a weakening of Japanese economic policy.

We believe that the Japanese can best ease tensions with the rest of the world by moving vigorously to open further their markets for imports (as well as their capital markets). The Japanese government recently announced a package of measures to further liberalize market access, which we greeted with cautious approval. These are a step in the right direction, but we are pressing them on both the follow-up and possible additional measures.

SECRET

REDUCTION OF EXPORT CREDIT SUBSIDIES

THE INTERNATIONAL ARRANGEMENT ON EXPORT CREDITS

ISSUE

With the EC acceptance on June 30, 1982 of a new Arrangement on Export Credits, this is no longer a contentious issue. There is nothing the EC wants from us right now. Indeed, this was never a U.S.- European problem. Generally, the Europeans have shared our view that official export credit subsidies are wasteful and should be reduced. Typically, only France opposed reductions of these subsidies. The EC's acceptance was the result of a hard-won consensus within the EC, with other countries persuading the French to cooperate.

German Economics Minister Lambsdorff personally intervened to persuade the French to accept the Arrangement Chairman's (Axel Wallen of Sweden) final compromise. The French sought to raise their negotiating leverage by touting this as a U.S.-EC problem. It was not.

RATIONALE FOR U.S. ACTION

-- The United States, along with 20 of the other 21 Arrangement Participants, views export credit subsidies as wasteful and trade-distorting and seeks a negotiated reduction of this practice. Exports should be differentiated by product price and quality and not by the level of official financing subsidy. The subsidies are not a long-term solution for domestic problems such as unemployment and inflation. When matched by foreign competitors, nothing is achieved to alter the competitive balance.

-- While the compromise did not eliminate subsidies, the U.S. Government accepted the compromise proposal in an effort to keep the Arrangement alive. We have no need to feel defensive on the export credit issue, as we have bent over backwards to accommodate the French. Specifically, for the French we:

1. Accepted a single subsidized interest rate for all currencies, while the United States strives for market rates differentiated by currency;

SECRET

2. Accepted much smaller increases to the minimum interest rate matrix than we and the other Participants had originally agreed to. All Participants but the EC (whose acceptance was barred by France) agreed to increases which would have raised the matrix from a weighted average of 10.20 percent to 11.60 percent. The compromise before us now increases the weighted average to 10.95 percent effective immediately and to 11.40 percent on January 1, 1983. (The weighted average is based on Eximbank's portfolio.)

3. Accepted a six month delay -- at French insistence -- in the effective date of these interest rate increases for the countries in which we are competing most strongly, e.g., Brazil, Korea, Mexico. (In practical terms, the new rates will not uniformly be in effect for one year since credit commitments, valid for six months, extended prior to January 1, 1983 will be the rates in effect before that date.)

4. Did not take the EC to task on its conditional acceptance of the new Arrangement terms. Rather, we are seeking resolution of these loose ends through further discussion. This "salami" approach has been typical of the French negotiating style with regard to export credits.

GATT MINISTERIAL

ISSUE

The EC has threatened to withdraw support for U.S. initiatives for the GATT Ministerial in response to recent U.S. trade actions. Especially vulnerable are U.S. proposals for work on services, investment, agriculture, and high technology. For other items, such as establishment of new rules on temporary increases in import protection (safeguards), the EC may give only lukewarm support.

BACKGROUND

While the EC was an early supporter of the concept of a 1982 GATT Ministerial, they did not anticipate the ambitious program that the United States and others have proposed. As a result, the EC has been unenthusiastic concerning most of the U.S. initiatives. In the first half of this year discussions with the EC were generally positive and non-confrontational, and led to grudging EC acceptance of most of our proposed agenda items.

The United States and the EC have a common position on the need for a GATT agreement on trade in counterfeit goods. However, in other areas the EC seeks solutions that are modest and that tend to put off the difficult decisions. The EC is particularly concerned with the prospects for changes in GATT rules on agriculture and has flatly stated that negotiations on this topic are out of the question. In regard to safeguards, the EC continues to seek authority to unilaterally impose discriminatory quotas only on certain suppliers (unilateral selectivity) as the price for completing an agreement. The EC has questioned our proposals regarding advanced technology goods and trade-related investment and has suggested that studies in these areas should not be completed in 1983 as recommended by the United States. The EC is somewhat more supportive on services, but has indicated that a GATT study will take years.

The EC agrees that something needs to be done to bring the newly industrializing countries more fully into the GATT system. The EC also has been more sympathetic than the United States to LDC positions in the North-South dialogue. So far, however, these positions have not led to support for the LDC trade initiative. A number of member countries (notably the Germans) are supportive of the proposal; the others simply are hesitant to support anything that could lead to further trade concessions by the EC, regardless of what they might get in return. Given their acceptance of the importance of the North-South issue in the GATT, the EC may ultimately support our proposal if there is no alternative. We will continue to consult with the EC in hopes that refinement of the proposal can be a more collaborative effort.

OUTWARD PROCESSING IN TEXTILES

ISSUE

During the preliminary stages of last year's Multifiber Arrangement (MFA) negotiations, the Commission negotiators proposed rolling back textile trade from their dominant suppliers but providing a partial offset through a special quota for products made from EC components. (These products are known as outward processing traffic, or OTP.)

We, and others, refused to accept language in the new protocol which would sanction OTP quotas and told the EC repeatedly that if it concluded agreements with OTP quotas, we would challenge them in the MFA or the GATT or both. By giving special treatment to apparel made from EC fabric through OTP quotas, the EC would be in violation of the most-favored-nation principle and would prevent EC textile suppliers from sourcing from the United States and other countries in filling those quotas.

In the first half of this year, we have concluded bilateral agreements with our major suppliers that did not include either cutbacks in quotas or special compensatory quotas for OTP. Because of our strongly-held view of the illegal nature of the outward processing traffic as envisaged by the EC, as well as our concern for equity, we informed Hong Kong and Korea that we would reopen our bilateral agreements, if such an OTP arrangement was included in their bilateral agreements with the EC. Likewise, we again restated our views in a letter from U.S. Chief Textile Negotiator (Murphy) to the EC Chief Textile Negotiator (Krenzler). EC Commissioner Davignon has subsequently expressed irritation that the United States is interfering in EC matters.

CURRENT SITUATION

The European Commission, because it has a negotiating mandate from the member states to pursue cutbacks in quotas to be compensated by outward processing arrangements, is continuing to seek such agreements despite the results of the Multifiber Arrangement negotiations. The EC, however, because of its highly protectionist mandate has been unable to conclude bilateral textile agreements with its major suppliers. Their next round of negotiations will most likely take place in September and October.

In recent contacts with the EC, we have stressed that the Murphy letter to Krenzler was only a reaffirmation of the U.S. position and not meant to be contentious, but to be sure that the record was clear. We again also highlighted our concerns over the negative and far-reaching implications for trade in other sectors if this approach is pursued.

U.S. DOMESTIC POLICIES

ISSUE

A number of U.S. domestic policies are of concern to the European Community because of the actual or potential impact on their interests. To put U.S.-EC economic relations in context, a partial list of such U.S. policies is presented in the background section.

BACKGROUND

1. Fiscal, monetary, and exchange intervention. See separate paper covering these issues.

2. Potential protectionist legislation being considered by Congress:

A) Local content regulations on motor vehicles sold in the United States. The bill would impose minimum levels of U.S. content (escalating with number of sales by manufacturer). The bill would sharply reduce Volkswagen sales in the United States. The Administration is firmly opposed to the bill, but it has over 200 co-sponsors in the House and has been favorably reported by a subcommittee.

B) Reciprocity. The Administration has obtained changes in the bill to make it acceptable, but the EC is still concerned that its tone is belligerent and that it gives the President new retaliatory authority.

C) Imports of works by U.S. authors. The Congress has passed an extension of existing law that in effect prohibits imports of works published abroad that are written by U.S. nationals. The Presidential veto of this legislation should reassure the EC, although it is still concerned that the veto might be overriden.

3. Gas Deregulation. The EC has long criticized U.S. regulation of natural gas prices on trade and energy grounds. On trade, the EC argued that artificially-low natural gas and oil prices gave U.S. producers of man-made fibers and chemicals an unfair cost advantage which resulted in U.S. exports to Europe displacing EC production. U.S. exports have, however, declined recently, quieting the issue. On the energy side, the EC has argued that price controls discourage increased gas production in the United States -- while at the same time the U.S. opposes the EC becoming increasingly dependent on the Soviets for gas.

4. Agricultural policies. The EC believes its sales of cheeses are limited by U.S. import quotas, and is concerned that the current U.S. support price for milk is stimulating surplus

production that might be moved into world markets with subsidies. The Administration is working on legislation to reduce dairy price supports. The EC has also expressed its intention to complain in the GATT about U.S. import quotas and fees on sugar. The quotas protect U.S. price supports, which were recently increased, while world prices have fallen sharply, due in part to subsidized EC exports.

5. State "Buy American" policies. Many states are considering bills that would give a preference to U.S. products, especially steel, in procurement by the state governments. The Administration has sent letters to governors and state legislatures opposing such legislation.

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